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Charitable Contributions of Patents and Other Intellectual Property

Notice 2004–7

The Internal Revenue Service (IRS) is aware that some taxpayers that transfer patents or other intellectual property to charitable organizations are claiming charitable contribution deductions in excess of the amounts to which they are entitled under § 170 of the Internal Revenue Code. In particular, the IRS has become aware of purported charitable contributions of intellectual property in which one or more of the following issues are present: 1) transfer of a nondeductible partial interest in intellectual property; 2) the taxpayer's expectation or receipt of a benefit in exchange for the transfer; 3) inadequate substantiation of the contribution; and 4) overvaluation of the intellectual property transferred. The purpose of this notice is to advise taxpayers that, in appropriate cases, the IRS intends to disallow all or part of these improper deductions and may impose penalties under § 6662. In addition, this notice advises promoters and appraisers that the IRS intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers of the intellectual property may be subject to penalties under §§ 6700, 6701, and 6694.

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)) that is made within the taxable year.

However, § 170(f)(3) provides generally that no charitable contribution deduction is allowed for a transfer to a charitable organization of less than the taxpayer's entire interest in property. For example, if a donation agreement states that a transfer to the donee of the taxpayer's interests in a patent is subject to a right retained by the taxpayer to manufacture or use any product covered by the patent, the taxpayer has transferred a nondeductible partial interest in the patent. For other examples of nondeductible partial interests, see Situations 1 and 2 of Rev. Rul. 2003–28, 2003–11 I.R.B. 594.

Generally, to be deductible as a charitable contribution under § 170, a transfer to a charitable organization must be a gift. A gift to a charitable organization is a transfer of money or property without receipt of adequate consideration, made with charitable intent. *See U.S. v. American Bar Endowment*, 477 U.S. 105, 117–18 (1986) (citing Rev. Rul. 67–246, 1967–2 C.B. 104, with approval); *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989); and § 1.170A–1(h)(1) and (2) of the Income Tax Regulations. A transfer to a charitable organization is not made with charitable intent if the transferor expects a return commensurate with the amount of the transfer. *Hernandez* at 690; *see also American Bar Endowment* at 116.

If a taxpayer receives a benefit in return for a transfer to a charitable organization, the transfer may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value of the benefit received, and only if the excess amount was transferred with the intent of making a gift (a "dual character" transfer). *See American Bar Endowment* at 118 (the taxpayer must "at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return.") In other words, the taxpayer must establish that it knew at the time of the transfer that the value of what it gave was greater than the value of what it received. *See id.* In this situation, the burden is on the taxpayer to show that all or part of the payment was a charitable contribution. *See* § 1.170A–1(h). All consideration provided by the charitable organization (other than benefits disregarded under § 1.170A–13(f)(8)) must be taken into account, including non-cash benefits.

For example, if a donation agreement states that the donee assumes a taxpayer's liability for a lease of a research facility, this assumption of liability is consideration from the donee. Likewise, a donee's promise to make available to the taxpayer the results of the donee's research, such as laboratory notebooks, data, and research files, is consideration from the donee. Similarly, a charitable organization's promise to hold a patent and maintain it for a period of time is consideration to a taxpayer if the taxpayer is benefited when others are prevented from purchasing or licensing the patent. *Cf.* Rev. Rul. 2003–28, Situation 3 (taxpayer received no benefit from restriction on donated patent). In each of these examples, the taxpayer has the burden of showing that it knew, at the time of the transfer, that the value of the donated property exceeded the value of the consideration it received from the donee. The taxpayer may deduct no more than this excess amount.

A charitable contribution is allowable as a deduction only if substantiated in accordance with regulations prescribed by the Secretary. Section 170(a)(1) and (f)(8). Under § 170(f)(8), a taxpayer must substantiate its contributions of $250 or more by obtaining from the donee a statement that includes: (1) a description of any return benefit provided by the donee; and (2) a good faith estimate of the benefit's fair market value. (See § 1.170A–13 for additional substantiation requirements.) The IRS intends, in appropriate cases, to disallow deductions if the taxpayer fails to comply with the substantiation requirements. *See, e.g., Addis v. Commissioner*, 118 T.C. 528 (2002).

If all requirements of § 170 are satisfied, including those discussed above, and a deduction is thereby allowed, the amount of the deduction may not exceed the fair market value of the contributed property on the date of contribution (reduced by the fair market value of any consideration received by the taxpayer). *See* § 1.170A–1(c)(1). Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Section 1.170A–1(c)(2). For example, the fair market value of a patent must be determined after taking into account, among other factors: (1) whether the patented technology has been made obsolete by other technology; (2) any restrictions on the donee's use of, or ability to transfer, the patented technology (see Rev. Rul. 2003–28, Situation 3); and (3) the length of time remaining before the patent's expiration.

DRAFTING INFORMATION

The principal author of this notice is Patricia Zweibel of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, please contact Ms. Zweibel at (202) 622–5020 (not a toll-free call).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 1016; 1.446–1T, 1.1016–3T.)

Rev. Proc. 2004–11

SECTION 1. PURPOSE

This revenue procedure provides an automatic consent procedure allowing a taxpayer to make a change in method of accounting under § 446(e) of the Internal Revenue Code for depreciable or amortizable property after its disposition. This revenue procedure also waives the application of the two-year rule set forth in Rev. Rul. 90–38, 1990–1 C.B. 57, for certain changes in depreciation or amortization. Finally, this revenue procedure modifies Rev. Proc. 2002–9, 2002–1 C.B. 327 (as modified by Rev. Proc. 2002–54, 2002–2 C.B. 432, Rev. Proc. 2002–19, 2002–1 C.B. 696, Rev. Proc. 2002–33, 2002–1 C.B. 963, and as modified and clarified by Announcement 2002–17, 2002–1 C.B. 561), and other revenue procedures to conform with § 1.446–1T(e)(2)(ii)(*d*) of the temporary Income Tax Regulations.

SECTION 2. BACKGROUND

.01 Section 446(e) and § 1.446–1T(e) provide that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner of Internal Revenue before changing a method of accounting for federal income tax purposes. Section 1.446–1T(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting.

.02 Concurrently with the issuance of this revenue procedure, §§ 1.446–1T(e)(2)(ii)(*d*) and 1.1016–3T(h) have been promulgated. Section 1.446–1T(e)(2)(ii)(*d*) provides the changes in depreciation or amortization (hereinafter, both are referred to as "depreciation") that are (and are not) changes in method of accounting under § 446(e). Section 1.1016–3T(h) provides that the "allowed or allowable" rule under § 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting under § 446(e).

.03 If a taxpayer uses an impermissible method of determining depreciation for a depreciable or amortizable property, the taxpayer adopts that method of accounting for the property when the taxpayer treats the property in the same way in determining gross income or deductions in two or more consecutively filed federal tax returns. *See* Rev. Rul. 90–38. The Internal Revenue Service and Treasury Department recognize that this two-year rule increases administrative and compliance costs associated with changes in depreciation because many taxpayers changing from an impermissible to permissible method of accounting for depreciation used the impermissible method for depreciable or amortizable properties placed in service in two or more taxable years before the year of change as well as for depreciable and amortizable properties placed in service in the taxable year immediately preceding the year of change. Accordingly, in the interest of sound tax administration, the Service and Treasury Department have decided to waive the two-year rule in Rev. Rul. 90–38 for a change in depreciation to which § 1.446–1T(e)(2)(ii)(*d*) applies.

.04 If a depreciable or amortizable property is transferred in a transaction in which the transferee is treated as the transferor for purposes of computing the depreciation allowance for the property with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted depreciable basis in the hands of the transferor (for example, in transactions subject to § 168(i)(7) or § 381(c)(6)), the transferee may file a Form 3115, *Application for Change in Accounting Method*, to change from an impermissible method of accounting adopted by the transferor for that portion of the basis of the property to a permissible method of accounting for depreciation for the same portion of the basis of the property, provided the impermissible method of accounting for that portion of the basis of the property has not been changed by the transferor (through filing, for example, a Form 3115 or an amended return) or by the Internal Revenue Service upon examination of the transferor's tax returns. In this case, the § 481 adjustment will include any necessary adjustments since the property's placed-in-service date by the transferor.

SECTION 3. METHOD CHANGE PROCEDURE FOR DISPOSED DEPRECIABLE OR AMORTIZABLE PROPERTY

.01 *Scope*.

(1) *Applicability*. Except as provided in section 3.01(2) of this revenue procedure, section 3 of this revenue procedure applies to a taxpayer that is changing from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation for any item of depreciable or amortizable property subject to § 1.446–1T(e)(2)(ii)(*d*):

(a) that has been disposed of by the taxpayer during the year of change (as defined in section 3.02(2)(b) of this revenue procedure); and

(b) for which the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable (hereinafter, both are referred to as "claimed less than the depreciation allowable"), in the year of change (as defined in section 3.02(2)(b) of this revenue procedure) or any prior taxable year.

(2) *Inapplicability*. Section 3 of this revenue procedure does not apply to:

(a) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(b) any property for which a taxpayer is revoking a timely valid depreciation election, or making a late depreciation election, under the Code or regulations thereunder, or under other guidance published in the Internal Revenue Bulletin (including under § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993, 1993–3 C.B. 1, 128 (relating to amortizable § 197 intangibles));

(c) any property for which the taxpayer deducted the cost or other basis of the property as an expense; or

(d) any property disposed of by the taxpayer in a transaction to which a nonrecognition section of the Code applies